

Central Intelligence Agency



Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

3 July 1984

Japan: The Decline of Special Tax Incentives
as a Tool for Industrial Targeting [REDACTED] UNCODED

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Summary

Japan's use of special tax measures to promote the development of selected industries has been limited in recent years by budgetary constraints and the increased involvement of a diverse set of interest groups in formulating tax policy. As revenues have risen, special incentives have declined from the equivalent of over 6 percent of corporate tax collections during 1965-75 to less than 3 percent last year. At the same time, tax measures have begun to serve a wider range of purposes. In the late 1950s and through the 1960s, tax benefits were designed explicitly to help basic materials and manufacturing industries become efficient enough to compete in world markets. Since then, the increasingly complex collection of groups involved in setting Japan's tax agenda has forced the use of special tax measures to serve a broader range of national objectives. The greater diversity in objectives has made it difficult to concentrate--target--benefits in the hands of specific industries. [REDACTED]

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This memorandum was prepared by [REDACTED] Japan Branch, Northeast Asia Division, Office of East Asian Analysis. Information available as of 3 July was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia Division, OEA, [REDACTED]

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Background

Tax incentives in the 1950s and 1960s were largely designed to serve the postwar consensus in favor of economic growth as a national priority. Special tax measures supported development of technologies considered crucial to Japan's economic development, rationalization of potential export industries to reduce production costs, and promotion of exports. They had an impact either by freeing additional funds for research and development and capital investment, or by stimulating demand for new products. The most expensive measures within these categories were special treatment for income from exports (a \$949 million revenue loss--i.e., subsidy--during the 1960s), special depreciation for machinery necessary to rationalize production facilities (\$333 million), and incentives for research and development (\$189 million). MITI's foremost objective in the 1950s and early 1960s was the development of heavy industries such as steel, electric power, shipbuilding, chemicals and petrochemicals. In FY 1970 these high priority industries enjoyed relatively low tax burdens--under 4 percent of the valued-added--in contrast to the 4.7 percent average for all industries and 5.3 percent for all manufacturing firms. [REDACTED]

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Japanese companies' practice of borrowing several times their equity during the late 1950s and 1960s meant that special tax measures were more important than revenue loss data suggested. Every dollar in revenue sacrificed by the government enabled companies to expand borrowing by several times that amount. During recessions, when added borrowing capacity was irrelevant, the added cash flow provided by tax incentives was sometimes crucial to a company's ability to pay interest on existing debt. In the 1970s, however, the importance of special tax measures declined as the debt-equity ratios of Japanese companies declined. The inflation of land and common stock values during the years of high growth also has meant that the market value of corporate equity is today far in excess of the book values upon which debt-equity ratios are based. Consultants with experience analyzing the finances of Japanese companies have noted that the debt-equity ratios of leading Japanese firms are not so different from those of US firms. [REDACTED]

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Broader Goals

MITI's ability to pursue industrial targeting through special tax incentives has been reduced by a diversification of national goals over the last decade. Recognition of the widespread damage to the environment that occurred during the years of rapid economic growth focused attention on the need to protect the environment. Correction of regional inequalities in economic development and improvement of housing and welfare

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facilities also have become major objectives. Special tax measures have been devised to promote all these objectives.

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These broader goals for tax policy have become particularly evident since the oil crisis. The higher cost of oil since 1973 and Japan's heavy dependence on suppliers in the unstable Persian Gulf region have dictated the diversion of government financial assistance, including tax incentives, to the development of alternative energy sources and suppliers. The economic viability of energy-intensive basic materials industries such as aluminum refining, petrochemicals, pulp and paper, chemical fertilizers, and cement has been undermined by high energy costs. As a result, MITI is assisting the capacity reduction efforts of these depressed industries, which further dilutes its ability to aid selected growth industries.

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While the uses for tax benefits have expanded, the absolute level of tax subsidies has stagnated. Faced with increasing budget deficits, the Ministry of Finance has lobbied to prevent increases in the value of special tax subsidies and to reduce their number. The absolute value of special tax subsidies today is slightly less than it was in 1974. Because tax revenues have risen in the interim, the level of special tax subsidies relative to corporate tax revenue has fallen from 5.4 percent in 1974 to less than 3 percent in FY 1983.

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Tax Incentives

There are three major categories of tax incentives benefiting corporations--added depreciation, tax-free reserves, and tax credits. These special measures cost the national treasury 258 billion yen (\$1.09 billion) in lost revenues in the fiscal year that ended in March. About 60 percent of the loss was due to special depreciation. Today special depreciation measures generally favor small business, while R&D-oriented credits and deductions favor big firms.

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Special Depreciation: In contrast to special measures of the past, which generally granted accelerated depreciation for the acquisition of machinery MITI designated as "important" and increased initial depreciation for "important" industries, current measures usually serve purposes other than the promotion of specific industries. Increased initial depreciation, which permits an industry to write off a higher than normal portion of the cost of new equipment in the year of purchase, demonstrates some of the broader goals tax policy is currently designed to achieve:

- The government offers 16-18 percent increased initial depreciation for buyers of waste processing facilities

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and industrial machinery designed to prevent environmental damage. Under this provision, for example, a manufacturer purchasing a non-jolting molding machine can depreciate 27 to 38.6 percent of its cost in the first year, compared with ordinary rates of 9 to 20.6 percent. The revenue loss was an estimated \$140 million in FY 1983.

- Another tax measure allows 14 percent increased initial depreciation for machinery acquired by small businesses (generally firms with no more than 300 employees and no more than 100 million yen--\$425,000--in capital). The rate rises to 30 percent for acquisition costs in excess of average yearly costs for the past five years. The estimated subsidy associated with this provision was about \$360 million for FY 1983.
- Increased initial depreciation is also allowed for production facilities built in underdeveloped areas, severely depressed areas, or Okinawa. Rates for machinery range from 18 percent in underdeveloped areas to 50 percent in free trade zones on Okinawa. Rates range from 8 to 50 percent in the case of factory buildings. Revenue losses were estimated at \$64 million for FY 1983. [redacted]

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Even plans to aid high-technology industries are becoming diluted by the growing number of special interests influencing tax policy formulation. For example, one measure included in the revisions of the Special Taxation Measures Law for FY 1984 provides 30-percent increased initial depreciation for new machinery that designated high-technology industries install in factories in areas (technopolises) for which an official development plan has been approved. The revenue loss in FY 1984 is estimated at \$4.5 million. Although the provision's reference to designated high technology industries could allow concentration of assistance in a few industries, political pressures already have expanded the list of designated industries to 70--too long to be truly selective. They include engineering plastics, high-quality agricultural chemicals, optical fiber and optical fiber cable, special refractory materials, printed circuit board materials, nuclear power generation equipment, industrial robots, solar cells, and digital audio and video discs. They do, however, encourage firms in a broad range of industries to move into product lines with a fairly high degree of added value. [redacted]

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Accelerated depreciation--a \$38 million subsidy in the last fiscal year--is also being made available to a wider range of beneficiaries because of pressure from special interests. Under

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accelerated depreciation, a purchaser of a depreciable asset may increase the amount of depreciation by a specified percentage for a specified period--usually five years. The rate for the first five years is 32 percent in the case of machinery purchased by enterprises participating in industry rationalization plans for small businesses or firms participating in structural improvement projects for the textile industry. Other provisions allowing accelerated depreciation are intended to encourage employment of the handicapped, urban renewal, the construction of grain silos and fireproof warehouses, and the construction of rental housing.

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Finance Ministry data for the fiscal year ending in March 1982 shows that small business benefits from both initial and accelerated depreciation much more than big business, particularly in manufacturing industries (see table 2). This reverses the pattern of a decade ago, when the largest companies--which tend to be more export oriented than small firms--were the biggest beneficiaries. In the early 1970s the construction, steel, and machinery industries topped the list for these subsidies. Today, in no manufacturing industry do the benefits accruing to the largest firms approach the 2.5-percent average for special depreciation as a percentage of all depreciation declared by manufacturing industries.

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Furthermore, the distribution of benefits by industry (see table 2) indicates that the industries MITI would most like to develop are not the primary beneficiaries of special depreciation. Electrical machinery, for example, which includes the favored computer, telecommunications equipment, and semiconductor fields, ranks only sixth among the listed industries. Printing-publishing appears at the top because it has many small businesses that are in a position to enhance productivity by introducing computerized printing processes. As in printing-publishing, small businesses produce much of the output of the metal products manufacturing, general machinery, and ceramics-stone-cement industries. Small businesses produce most of the textile industry's output as well, and because some important textile producing regions are located outside major metropolitan areas, many textile firms benefit from tax measures intended to aid regional development as well as small business.

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Special depreciation contributes to an industry's development in one of two ways. For companies buying new machinery, it lowers the initial after-tax cost of an investment. Lower costs, in turn, make faster growth possible. For producers of machinery, lower costs for their customers should lead to higher sales. Thanks to this increased demand, manufacturers of capital goods such as robots, numerically

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controlled machine tools, and computers become secondary beneficiaries of special depreciation for small business¹. [REDACTED]

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Tax-Free Reserves: Tax-free reserves continue to benefit several growth industries but are also now used to support development of industries serving wider national objectives. For example, the largest beneficiary is currently the electric power industry--which plays the central role in Japan's efforts to develop alternate sources of energy. Sixteen percent of the construction costs of nuclear power plants can be credited to a tax-free reserve that does not have to be added back to income until seven years after the completion of construction. The reserve will cost the government \$123 million in revenue this year, according to Ministry of Finance estimates. In addition, manufacturers of nuclear power generation equipment should benefit from increased demand. [REDACTED]

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The computer industry benefits from reserves for losses resulting from the repurchase of computers and the correction of defective software. The percentage of a computer's sale price that can be placed in the reserve is determined by actual experience with losses. Thirty-five percent of the development cost of an operating system and 22 percent of the cost of a program can be placed in the reserve for corrections. Such reserves enable Japan-based computer manufacturers to lower selling prices and to offer equipment to customers on a trial basis. Although these reserves favor the computer industry over other Japanese industries, they do not discriminate against imported computers. Sellers of imported computers and software also can maintain reserves. Most other special reserves either serve a general, non-industry-specific policy objective, are slated for abolition, or are no longer causing a loss of government revenue. [REDACTED]

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Tax Credits and Deductions: Special credits and deductions provide greater benefits to large firms, especially those involved in research and development. Because of the decline in size of all tax benefits, however, the advantages are insignificant compared with those offered in the United States.

¹ The revenue loss estimates cited here as a measure of the value of special depreciation provisions only take into account the benefit accruing to the buyer, not the seller. We expect to launch a new research project shortly that will attempt to measure both effects. [REDACTED]

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The biggest tax credit Tokyo offers is for incremental research and development expenditures, which is expected to cost \$162 million in FY 1983. Since hitting a low of \$75 million in FY 1978, usage of the credit has been rising faster than private-sector spending on R&D. The Japanese credit, however, is less generous than a similar US credit. A company with continually growing R&D expenditures could claim a 25 percent credit on expenditures above the average expenditure in the past three years in the United States, but only 20 percent of a higher base--the previous year's expenditures--in Japan. In addition, the credit in Japan can never exceed 10 percent of income, while there is no limit in the United States. A National Science Foundation study estimates that the US credit produces a \$2 billion annual tax incentive in contrast to the \$162 million that the Finance Ministry expected to lose in FY 1983 because of Japan's credit. [redacted]

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Through March 1986 small businesses acquiring qualified industrial robots and electronic equipment are eligible for a tax credit equal to 7 percent of acquisition cost or a 30 percent special depreciation allowance. The Ministry of Finance estimates the revenue loss for FY 1984 at \$90 million. [redacted]

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The Politics of Balance

The growing diffusion of tax incentives among types and sizes of industries reflects the multiplicity of groups that now have a say in developing tax policy. The actors in the process fall into four major categories. [redacted]

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The Bureaucracy: Each May the director general of MITI's Industrial Policy Bureau issues policy guidelines for the fiscal year that begins the following April and solicits comments from business and trade associations on specific proposals already in hand. During this process each bureau or agency within MITI tends to act as a proponent of its own clients--the Small and Medium Enterprises Agency pushes incentives for small business, the Basic Industries Bureau works on behalf of steel and chemicals, and the Machinery and Information Industries Bureau promotes the electronics, computer, and machinery industries. As a result, MITI itself supports tax incentives that benefit a broad spectrum of industries, not just a chosen few. Small business generally fares well because small businessmen are important electoral supporters of the ruling Liberal Democratic Party (LDP). On the other hand, the auto industry and large electrical machinery manufacturers, whose workers are represented by unions supporting a middle-of-the-road opposition party, often have less clout than their size suggests. [redacted]

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Although MITI may take the initiative in proposing a special tax incentive, revisions of the Special Tax Measures Law are actually drafted in the Finance Ministry's Tax Bureau. The Ministry's draft takes into account requests from MITI and other ministries, interest groups such as the Japan Medical Association or the Japan Chamber of Commerce, and the LDP's Taxation Research Council. [REDACTED]

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The Tax Bureau's draft also considers the macroeconomic and fiscal needs of the government. From the Finance Ministry's perspective, the gap between revenues and expenditures that first developed in FY 1975 is the dominant economic and fiscal reality. Political considerations initially dictated that efforts to close the gap be concentrated on the revenue side. The Finance Ministry's inclination has been to reduce the size and number of special tax measures benefiting business because this is one of the easiest ways to increase revenues. The existence of termination dates for all special tax measures places on interest groups the burden of repeatedly justifying the special incentives they enjoy. [REDACTED]

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The Tax Advisory Commission: Broader public interests are also injected into the process of tax policy formulation when Tax Bureau officials submit their list of alternative policies to the Tax Advisory Commission. The commission's members, all appointed by the prime minister for three-year terms, include former government officials, academic experts on public finance, journalists, bankers, businessmen, union leaders, agricultural representatives, and local politicians. The broad composition of its membership makes the commission useful as an arbiter among diverse interest groups and as a builder of consensus on broad questions of tax policy. [REDACTED]

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The LDP's Taxation Research Council: In addition to government ministries and the advisory commission, a small group of LDP politicians dubbed the "tax mafia" by the Japanese press plays a key behind-the-scenes role in setting tax policy. Because many of the politicians involved are former Finance bureaucrats, they share the concern of that Ministry and the Tax Advisory Commission for fiscal restraint. As politicians, however, they also recognize the value of tax incentives for politically popular programs such as housing, small business, and regional development. [REDACTED]

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Each September the council's secretariat collects proposals to revise the tax laws from interest groups such as the Federation of Economic Organizations and the Central Association of Agricultural Cooperatives. Last fall, approximately 1,000 items proposed by some 150 organizations were included in the "telephone book" put together by the secretariat. The book is

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given to the Tax Bureau for item-by-item review. Each item is marked to indicate acceptance, rejection, or the need for further consideration. The council then reviews the bureau's grading and may call in Finance Ministry officials to explain a decision. On some items the council may force the bureaucrats to change a ruling. [REDACTED]

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Interest Groups: Special interest groups also inject a wide range of views into the tax policy formation process. Interest groups lobby during public hearings held by the Tax Advisory Commission each fall and also take opportunities to influence members of the LDP Taxation Research Council. [REDACTED]

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Changing Tools of Industrial Policy

Both the industries MITI selects for promotion and the tools it uses to promote them change over time. In recent years, for example, MITI has established special offices to identify ways in which government intervention would assist the fine ceramics and biotechnology industries. [REDACTED]

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We doubt, however, that MITI will be able use other tools to compensate completely for the limitations on the effectiveness of special tax measures. The pressures that lead to the dispersion of tax subsidies among a wider spectrum of industries affect other tools as well. For example, broader political considerations prevent budgetary subsidies--about \$2 billion a year at present--and loans from official institutions from being concentrated on high priority industries. The computer and semiconductor industries, which MITI has been promoting for over a decade, receive a share of the \$5 billion in subsidies directed toward the manufacturing industry proportionate to their contribution to total value-added by manufacturing. Computer and integrated circuit manufacturers accounted for over 1.6 percent of value-added by manufacturing, but the \$60.5 million in the FY

[redacted]

1983 budget for research and development on fourth and fifth generation computers, a high-speed scientific computer, new semiconductor elements and software development projects was only 1.2 percent of all budget items related to manufacturing industry². Moreover, manufacturing industry takes a back seat to agriculture-forestry-fisheries, which received 48 percent of the \$18 billion allocated in FY 1983 for industry and technology-related programs, and the transportation and communications sector, which received 21 percent--primarily to cover the deficit of Japan National Railways. [redacted]

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The same inconsistency between the widely touted objective of promoting high technology and the actual distribution of benefits exists in the case of official financing. Of the \$89.8 billion government financial institutions are authorized to loan out in the fiscal year that began in April, 25 percent will be for housing, 19 percent for small business, and 14 percent for environmental improvement. The diversity of objectives in general also is present in the lending programs of the Japan Development Bank and the Small Business Finance Corporation, the institutions established specifically as instruments of industrial policy. In order of magnitude, the largest beneficiaries of Development Bank loans are electric power companies, maritime shippers, private railroads, real estate companies, oil refining, steel and chemicals. Metal products, general machinery, and cement lead in the case of the SBFC.

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² The 1.2 percent would be higher if the \$88 million that Nippon Telegraph and Telephone, the government-owned telecommunications monopoly, allocated for data processing technology and integrated circuit research was included. We exclude it because NTT research is funded by the fees paid by users of its services rather than taxes and because the allocation is determined by the NTT bureaucracy which, subject to the approval of the Diet, sets its priorities outside the industrial policymaking process dominated by MITI. [redacted]

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Table 1
Special Tax Measures
In Perspective

In billion US\$

	<u>FY 1974</u>	<u>FY 1983</u>
GNP	471.6	1,175*
General Account Expenditures	67.5	212.7
Total General Account Revenue	65.6	136.4
Corporate Tax Revenue	19.9	40.1
Revenue Losses Due to Special Tax Measures	0.9	1.1

*A forecast. All other figures are initial budget values.

Table 2
Special Depreciation As a Percentage of Total
Depreciation by Industry and Size of Firm in FY 1981

Industry	Average	Size of Firm (Paid-in capital in Million Yen)						
		Under 2	2-5	5-10	10-50	50-100	100-1,000	Over 1,000
All Industries	2.8	1.4	2.4	4.0	4.4	4.2	1.7	2.4
Manufacturing	2.5	3.0	4.6	5.4	6.4	7.4	2.4	0.6
Food Products	2.7	1.8	3.2	4.4	3.5	10.0	2.0	1.1
Textiles	5.8	-0-	3.2	7.6	9.9	11.1	1.7	2.2
Apparel	2.4	-0-	7.7	0.6	0.8	2.7	-	2.0
Lumber & wood	3.1	2.1	-0-	1.6	7.4	2.9	2.0	1.1
Pulp & paper	2.0	-0-	-0-	3.7	4.6	8.9	3.6	0.1
Printing/ publishing	9.0	11.1	7.3	14.5	12.9	11.9	0.5	1.1
Chemicals	0.8	-0-	-0-	3.5	3.3	5.5	1.4	0.1
Oil refining & coal products	1.4	-0-	0.8	2.9	1.9	2.6	1.9	1.4
Ceramics, stone & cement	3.5	-0-	7.9	0.5	5.0	3.6	5.8	1.9
Steel	0.6	2.3	-0-	1.5	5.1	5.5	2.4	0.1
Nonferrous metals manufacturing	1.2	-0-	-0-	13.1	6.4	2.9	2.5	0.7
Metals products manufacturing	3.8	2.1	5.2	6.8	4.5	4.7	1.5	1.2
General machinery	3.8	3.3	5.5	6.2	8.5	5.5	2.6	0.9
Electrical machinery	3.4	0.4	14.2	1.8	6.6	18.8	6.0	1.3
Transportation machinery	1.7	2.4	3.9	10.5	13.6	7.7	1.7	0.1
Precision machinery	2.7	-0-	0.9	5.2	6.3	5.7	2.3	0.8
Shipbuilding	1.0	-0-	-0-	0.6	4.1	5.6	1.1	0.9

Source: Ministry of Finance survey of corporate finances.
Small Businesses have a paid-in capital under 100 million yen.

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Table 3

Disposition of Tax Changes for FY 1983

Requested by the Japan Machinery Federation

Item

1. Extension of special first year depreciation for computerized machinery including high-performance computer-controlled robots and computer-aided design equipment

Action: Abolished.

Remark: Encouraged companies to buy advanced equipment, which could be imported as well as domestically produced. Probably abolished because of the attention that the Houdaille petition focused on such special provisions. This year the Diet approved a similar provision for small businesses only effective for two years beginning in April 1984.

2. Extension of provision allowing maintenance of accounting reserves to cover losses from the return of electronic computers.

Action: Extended for two years, but size of reserve was reduced.

Remark: Considered necessary by the federation to strengthen market position of domestic manufacturers threatened by the introduction of IBM 308X series and as compensation for reduced tariffs on computers.

3. Extension of provision allowing companies to maintain special accounting reserves for correction of computer programs.

Action: Extended for two years, but size of reserves was reduced.

Remark: Considered essential to Japan's effort to upgrade software capabilities.

4. Addition of the facsimile manufacturing industry to those allowed to maintain accounting reserves for the repair and guarantee of products.

Action: Added.

Remark: Enables manufacturers to expand the use of guarantees as a sales tool. Effect is to speed the growth of an already fast developing product line.

5. Extension of 30-percent additional depreciation (or a 7-percent tax credit) for acquisition of certain energy-saving machinery or facilities by small business.

Action: Action deferred because measure does not expire until March 1984.

Remark: In early 1984 the Diet approved extension of the program for 2 years.

6. Extension of special first-year depreciation for pollution prevention equipment, non-polluting production facilities, and waste reprocessing facilities.

Action: Eligibility of specific types of machinery to be reexamined.

Remark: A response a widespread public concern over pollution. Primary beneficiaries are probably basic materials industries such as steel and chemicals.

7. Extension of special first-year depreciation allowance for investments by small business in excess of a firm's level for the past five years.

Action: Rate was increased from 14 to 30 percent and extended for two years.

Remark: A macroeconomic rather than an industry-specific, measure intended to spur capital investment by small business, which was much weaker than that of big business in the recent recession.

8. Extension of provision allowing small businesses to maintain accounting reserves for development of overseas markets.

Action: Extended for two years.

Remark: MOF will try to abolish in FY 1984 as part of its campaign to eliminate export promotion measures.

9. Reduce the depreciation period for integrated circuit production equipment.

Action: No action taken.

Remark: Would substantially increase cash flow of semiconductor makers who are spending large sums to get the 256K RAM memory chip into mass production before US competitors. No action taken because present period accurately reflects real useful life.

10. Extension of a reduction in the commodity tax on electric passenger cars and an expansion of the scope of the provision.

Action: Extended for two years. Combination passenger-cargo vehicle also made eligible for the reduction.

Remark: Development of electric cars is being promoted as a means of reducing both exhaust pollution and energy consumption.

11. Increase to \$1,275 the maximum value of assets with a useful life of less than one year which are eligible to be treated as an expense in the period of acquisition.

Action: Unknown.

Remark: Limit was originally set at \$425 in 1974. The provision simplifies accounting procedures.



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